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IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

No. [redacted] 196

FRUEHAUF CORPORATION, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

ALFONS LANDA
RAYMOND C. CUSHWA
GEORGE D. WEBSTER
Attorneys for Petitioner
1000 Vermont Ave., N. W.
Washington, D.C. 20005

Of Counsel:

DAVIES, RICHBERG, TYDINGS,
LANDA & DUFF
Washington, D. C.

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Petitioner, Fruehauf Corporation, prays that a writ of certiorari issue to review the decision of the United States Court of Appeals for the Sixth Circuit in this case.

OPINIONS BELOW

The opinion of the Tax Court (R. 96a-140a) is reported at 42 T.C. 83. The opinion of the Court of Appeals (Appendix A, *infra*, pp. 1a-8a) is reported at 356 F. 2d 975.

JURISDICTION

The judgment of the Court of Appeals was entered March 10, 1966 (Appendix A, *infra*, p. 9a). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

This case involves petitioner's Federal income taxes for the years 1954, 1955 and 1956. The Commissioner of Internal Revenue, in 1950, determined that petitioner must inventory its used trailers on the $1 per unit method. In 1959 the Commissioner decided that petitioner must change to the lower of cost or market value method of inventorying such trailers, making such determination retroactive to 1954 and subsequent years. Both the Tax Court and the Court of Appeals held that the Commissioner's 1950 decision was a mistake of law, and hence could be reversed retroactively. The questions presented are:

1. Whether the Commissioner may retroactively reverse his decision requiring a taxpayer to use a particular method of accounting, where such ruling did not constitute a mistake of law.

2. Whether the discretion given the Commissioner by Section 41 of the Internal Revenue Code of 1939 (corresponding to Section 446(a) and (b) of the 1954 Code), to require a taxpayer to use a method of accounting which clearly reflects income, is broad enough to authorize him to require a taxpayer to use an erroneous inventory method in order to protect the revenue, so that such exercise of his discretion is not a mistake of law.

STATUTES AND REGULATIONS INVOLVED

Sections 22(c) and 41 of the Internal Revenue Code of 1939, and the pertinent provisions of the regulations issued thereunder are set forth in Appendix B, *infra*, pp. 10a-14a.

STATEMENT

The petitioner, since its organization, has been primarily engaged in the business of manufacturing commercial truck-trailers. It began acquiring used trailers about 1926, and adopted the practice of inventorying them at $1 per unit. (R. 101a, 103a) Although its returns were examined and audited by the Internal Revenue Service, this practice was not changed for years prior to 1942. In 1948, the petitioner received a revenue agent's report for the years 1942 through 1945, in which the agent proposed to change the closing 1945 used trailer inventory to the lower of cost or market value method. The petitioner protested this change, contending that if the change were made as of December 31, 1945, similar adjustments should be made in opening and closing inventory for the four years 1942 through 1945. At a conference in the office of the Internal Revenue Agent in Charge in Detroit in September, 1948, a tentative agreement was reached to change the used trailer inventories for the four years in question to the lower of cost or market value method. (R. 104a) On November 9, 1948, the petitioner executed a Form 874 agreeing to deficiencies for such four years computed in accordance with the agreement, and on February 11, 1949, it was notified by the Detroit office that the case would be disposed of in accordance with the agreement evidenced by Form 874. (R. 105a)

As of January 1, 1949, partly because petitioner thought the inventory issue was settled, in accordance with the Form 874, and partly in the interest of more accurate reporting of annual earnings, petitioner changed, on its books, its method of inventorying used trailers to the lower of cost or market value method. (R. 106a)

It was necessary for the agreement evidenced by the Form 874 to be approved by the National Office of the Internal Revenue Service, since the allowance of certain claims for relief under Section 722 of the 1939 Code resulted in over-assessments which were required to be reported to the Joint Committee on Internal Revenue Taxation of Congress (Section 3777, 1939 Code). In the course of the preparation of their report, representatives of the Chief Counsel of the Internal Revenue Service questioned the propriety of the change in used trailer inventory method, since such change would result in a double deduction, that is, the amount of the opening 1942 inventory would escape tax. (R. 107a-109a) A memorandum from the Chief Counsel's office to the Income Tax Unit stated:

> "While taxpayer's method of computing inventories of used trailers is obviously erroneous, it is the opinion of this office that a correction should not be made in this case in a manner that will result in the substantial benefit to the taxpayer as now proposed. * * * Unless a settlement on a more equitable basis can be reached or the correction made starting in a year where the opening inventory is small and the double benefit would not be so great (as, for instance, the year 1944), it is the opinion of this office that the Government should refuse to permit a change in the erroneous method of inventorying used trailers used by the taxpayer." (R. 109a, 110a)

After several conferences between representatives of the petitioner and the Internal Revenue Service, the Chief Conferee of the Detroit office advised petitioner on June 23, 1950, that it had been decided to restore petitioner's used trailer inventory to the $1 per unit method. On July 5, 1950, a revised Form 874, recomputing income for the years 1942-1945 by the use of the $1 per unit method, was executed. Petitioner's taxes for said years were finally determined in accordance with said Form 874, after the Commissioner had signed and filed his report with the Joint Committee on Internal Revenue Taxation. (R. 111a, 112a)

In the meantime, after the tentative agreement of September 10, 1948, but before June 23, 1950, petitioner filed a claim for refund for 1946, an amended return for 1947, and an original return for 1948, all based on the inventorying of used trailers at the lower of cost or market value method. The Commissioner rejected the 1946 claim for refund, and the amended 1947 return, and recomputed the 1948 return by inventorying used trailers on the $1 per unit method. Such action was taken in conformity with the determination of taxes for the years 1942-1945 as reflected in the Form 874 dated July 5, 1950. For 1949 and subsequent years, petitioner's income tax returns were filed on the basis of inventorying used trailers on the $1 per unit method. The returns for the years 1949 through 1953 were examined by a revenue agent and, while the $1 per unit method was questioned, it was not disturbed. However, on March 31, 1959, the revenue agent informed petitioner that the National Office of the Internal Revenue Service had decided to reverse its previous decision with respect to used trailer inventories, commencing with the year 1954, and thereafter

the deficiency notices which form the basis for this proceeding were issued. (R. 113a, 114a)

In the Tax Court petitioner contended (1) that the Commissioner was estopped to reverse his 1950 decision requiring petitioner to use the $1 per unit method of inventorying used trailers, or (2) in the alternative, he was precluded from reversing that decision retroactively, that is, in any year prior to 1959. In the Court of Appeals only the latter contention was urged. (Appendix A, *infra*, p. 5a)

Both the Tax Court and Court of Appeals held that the Commissioner's action in 1950, requiring petitioner to use the $1 per unit method, constituted a mistake of law, and hence, under the decisions of this Court, he could reverse such ruling retroactively.

REASONS FOR GRANTING THE WRIT

I. The Holding of the Court Below That the 1950 Decision of the Commissioner Was a Mistake of Law is in Conflict With Decisions of the Courts of Appeals for the Second and Third Circuits and of the Court of Claims, as Well as With the Intendment and Rationale of Decisions of This Court

Whether or not the 1950 decision of the Commissioner could be reversed in 1959, with retroactive effect to 1954, depends upon whether such 1950 decision was or was not a mistake of law. It is well settled that if such decision did constitute a mistake of law the Commissioner has the power to reverse his decision retroactively. For example, the Court of Appeals for the Sixth Circuit held in *H.S.D. Co.* v. *Kavanagh*, 191 F. 2d 831 (6th Cir. 1951), and *Woodworth* v. *Kales*, 26 F. 2d 178, (6th Cir. 1928), that under the circumstances of those cases the Commissioner could not re-

verse his prior rulings.* Those cases were relied on by the petitioner in *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180 (1957), but this Court distinguished them, saying (p. 184):

> "Petitioner's reliance on *H.S.D. Co.* v. *Kavanagh,* 191 F. 2d 831, and *Woodworth* v. *Kales,* 26 F. 2d 178, is misplaced because those cases did not involve correction of an erroneous ruling of law."

This Court again expressed the same position in its decision in *Dixon* v. *United States,* 381 U.S. 68 (1965), where it was stated (p. 72):

> "In *Automobile Club of Michigan* v. *Commissioner, supra,* at 183-184, we held that the Commissioner is empowered retroactively to correct mistakes of law in the application of the tax laws to particular transactions."

The clear corollary of the holding in these cases is that the Commissioner does not have power to reverse retroactively a ruling that does not constitute a mistake of law. This is a succinct statement of petitioner's position in this case.

In another field, this Court has held that an administative agency may not retroactively reverse an exercise of broad discretionary power. In *Arizona Grocery Co.* v. *A.T.&S. F. Ry. Co.,* 284 U.S. 370 (1932), the Interstate Commerce Commission in 1921 had determined a certain rate. In 1925 it attempted to make a new rate, with retroactive application. The Court held that it was beyond the Commission's power to change its 1921 decision retroactively, and that its 1925 decision could

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* While the petitioner relied strongly on *H.S.D. Co.* v. *Kavanagh* below, the Court of Appeals (Appendix A, *infra,* p. 8a) summarily dismissed this decision as being decided on particular facts.

be applied only prospectively. In its opinion, this Court said (p. 390):

> "Where the Commission has, upon complaint and after hearing, declared what is the maximum reasonable rate to be charged by a carrier, it may not at a later time, and upon the same or additional evidence as to the fact situation existing when its previous order was promulgated, by declaring its own finding as to reasonableness erroneous, subject a carrier which conformed thereto to the payment of reparation measured by what the Commission now holds it should have decided in the earlier proceeding to be a reasonable rate."

By statute, the Interstate Commerce Commission is given broad power to fix rates. That power is comparable to the wide discretion (hereinafter discussed) given the Commissioner of Internal Revenue in the accounting method area. In either case, the exercise of that power is not an interpretation of a statutory provision, so as to constitute a mistake of law if erroneous; rather it is the exercise of a discretion entrusted by Congress. In the case of Section 41 of the 1939 Code, Congress provided that a taxpayer's accounting method must be such "as in the opinion of the Commissioner does clearly reflect the income." Such discretion is fully as broad as that given the Interstate Commerce Commission to prescribe rates, and a ruling made pursuant thereto should be as immune from retroactive reversal as was the ruling of the Commission in the *Arizona Grocery* case.

The Commissioner in 1950, required petitioner to inventory its used trailers on the $1 per unit method, even though such method was "obviously erroneous", because a change to the lower of cost or market value

method would result in a "substantial benefit to the taxpayer," i.e., it would have permitted a substantial amount to be twice deducted.

The Tax Court held, and the Court of Appeals affirmed, that the Commissioner went beyond his power in requiring, or permitting, the petitioner to use an incorrect method of accounting, even though such action was taken in order to avert a double deduction; and that such action constituted a mistake of law. This holding is contrary to decisions in the Second and Third Circuits, and in the Court of Claims.

In *Commissioner* v. *O. Liquidating Corp.*, 292 F. 2d 225 (3rd Cir. 1961), the taxpayer changed its method of accounting from an erroneous, to a correct, method. The Commissioner refused to recognize this change, contending that no change of accounting method could be made without his consent. The Tax Court held that the taxpayer's action was proper and that the change was not one in accounting method but merely the correction of an error. The Court of Appeals for the Third Circuit reversed, holding that the change was one in accounting method, and that it was invalid without the Commissioner's consent. It said:

> "The rationale of the Regulation here involved is that virtually any material change in the method of reporting income or deduction items will result in a distortion of taxable income, and it is the Commissioner's responsibility to insure that the distortion will not be to the detriment of the Government. The Commissioner accomplishes this by withholding his consent until the taxpayer agrees to adjustments that will prevent, *inter alia*, duplication of deduction items or omission of income items as a result of the change. (p. 230)

* * * * *

"It is not dispositive that taxpayer's former consistent method of reporting the insurance dividends in the instant case was not correct under the accrual accounting system since it could not be changed without the Commissioner's prior consent." (p. 231)

* * * * *

"The 'broad discretion' of the Commissioner in determining whether to consent to a change was settled in *Brown* v. *Helvering,* 1934, 291 U.S. 193, 54 S. Ct. 356, 78 L. Ed. 725. See also *Commissioner of Internal Revenue* v. *Hansen,* 1959, 360 U.S. 446, 467, 79 S. Ct. 1270, 3 L. Ed. 2d 1360." (p. 231)

A similar set of facts was before the Court of Appeals for the Second Circuit in *American Can Co.* v. *Commissioner,* 317 F. 2d 604 (1963). There that Court also reversed the Tax Court and held that a change from an erroneous to a correct accounting method could be made only with the Commissioner's consent, and under such conditions as the Commissioner might see fit to impose. In the course of its opinion, it said (p. 606):

"A change in accounting method will almost certainly result in some distortion of taxable income, and the Commissioner must insure that such distortion is not overly detrimental to the government."

In *In re Sperling's Estate,* 341 F. 2d 201 (2d Cir. 1965), the Court said:

"The question presented is whether the petitioner can successfully oppose the Commissioner's determination simply by pointing out that the Commissioner has worked within the framework of the taxpayer's own, improper accounting system." (p. 204)

In other words, the Court was called on to decide whether the Commissioner's discretion was broad enough to countenance a taxpayer's erroneous accounting method, or whether he had a duty to require a change to a proper method. The Court held that the Commissioner did not have to change the taxpayer's erroneous method, saying:

> "Of course, it is possible that the taxpayer's accounting system may be so inadequate that the Commissioner has no choice but to redetermine the liability on the basis of his own system; this apparently was the case in *Elmer D. Willis, supra.* But where the taxpayer does have a rational, though improper, system, we think that the Commissioner may choose to let it stand and to pursue only specific deficiencies within it." (p. 204)

In *John Wanamaker Philadelphia, Inc.* v. *United States,* F. 2d , decided by the Court of Claims on April 15, 1966, the taxpayer sought to increase its opening inventory by excluding therefrom the amount of a reserve for future markdowns, the use of such a reserve being contrary to the regulations. The Government contended that the income of the taxpayer would not be clearly reflected if the reserve (which the taxpayer had used for many years) were eliminated. In rejecting the taxpayer's argument and in permitting the government to take a position which violated its own regulations, the Court of Claims stated:

> "Part of the argument is that the opening, but not the closing, inventory was reduced by a reserve for future markdowns, which was an illegal reduction under sections 29.22(c)-2 and (c)-8 of Treasury Regulations 111. The theory is that income cannot be clearly reflected if the accounting method violates the law. The weight of authority

is strongly against this argument. There are many cases in which taxpayers have attempted to right a previous accounting error by changing the method. Where the advantage runs solely to the taxpayer via a double deduction or an exclusion of an income item, the courts have said that the prior method, *though illegal,* was consistent and the changes must be accompanied by an adjustment—presumably to clearly reflect income. *Hackensack Water Co.* v. *United States, supra; Wright Contracting Co.* v. *Commissioner, supra; Broida, Stone & Thomas, Inc.* v. *United States, supra; Commissioner* v. *O. Liquidating Corp., supra.*" (Emphasis supplied)

Thus, both the Second and Third Circuits and the Court of Claims have held that the Commissioner is not obligated to change or permit a taxpayer to change a taxpayer's method of accounting even where such method is erroneous. As a consequence, he commits no mistake of law in failing or refusing to make such change.

In the instant case, the Commissioner, in 1950, required the petitioner to use the $1 per unit method, a method of accounting characterized by the Tax Court and the Court of Appeals as "erroneous", and refused to change the petitioner's method of inventorying used trailers to the lower of cost or market value method, to insure that income would not be distorted as the result of a double deduction. In each of the cases cited above, namely, *O. Liquidating Corp. American Can, Sperling,* and *Wanamaker Philadelphia,* and in the instant case, the continuance of the erroneous method of accounting operated to the benefit of the revenue.

The Commissioner not only was acting within the scope of his power, but was carrying out what the

Second Circuit considered a positive duty. The holding of the Courts below in the instant case, that the Commissioner's failure to change petitioner's used trailer inventory method constituted a mistake of law, is in clear conflict with the decisions of the Second Circuit in the *American Can* and *Sperling* cases, the Third Circuit in *O. Liquidating Corp.*, and the Court of Claims in *Wanamaker Philadelphia*.

The decisions below in the instant case are likewise in conflict with the decision of this Court in *Dobson* v. *Commissioner*, 320 U.S. 489 (1943). There the taxpayer, in 1930 and 1931, sold 200 shares of stock out of 300 which he had purchased in 1929. Later he filed suit against the seller, alleging fraud, and in 1939 recovered a substantial sum, no part of which he reported as income in his 1939 return. The Commissioner audited that return and included as income that portion of the recovery which was allocable to the shares which had been sold. The Board of Tax Appeals held that no part of the amount recovered was taxable. The Circuit Court of Appeals reversed.

At that time, the statute authorizing review by the Circuit Courts of Appeals of decisions of the Board of Tax Appeals (Sec. 1003, Revenue Act of 1926) provided:

> "(b) Upon such review, such courts shall have power to affirm or, if the decision of the Board is not in accordance with law, to modify or to reverse the decision of the Board, with or without remanding the case for a rehearing, as justice may require."

This Court held that the Circuit Court of Appeals had no jurisdiction to disturb the decision of the Board

(the name of which had in the meantime been changed to the Tax Court); since such a decision could be modified or reversed only if the Board had made an error of law, and that no mistake of law had been made. In the course of his opinion Mr. Justice Jackson said (p. 499):

> "But conflicts are multiplied by treating as questions of law what really are disputes over proper accounting."
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> * * * * *
>
> (p. 504) "What, in the circumstance of this case, was a proper adjustment of the basis was thus purely an accounting problem and therefore a question of fact for the Tax Court to determine."
>
> * * * * *
>
> (p. 506-7) "The error of the court below consisted of treating as a rule of law what we think is only a question of proper tax accounting."

In the instant case the decision which the Commissioner made in 1950, to require the petitioner to inventory used trailers on the $1 per unit method, was one involving methods of accounting. It was so held by the Tax Court, which said (R. 129a) "We think petitioner's practice of inventorying used trailers at $1 each was a 'method of accounting.'"

If a decision of the Tax Court as to proper accounting is not one involving a question of law, then similarly a decision or ruling by the Commissioner regarding a method of accounting to be used by a taxpayer does not involve a question of law, and the Commissioner's determination to require a taxpayer to use a particular accounting method, even though such method is erroneous, cannot be a mistake of law. This is particularly true where the Commissioner, in the

exercise of his broad discretion in the accounting area, protects the revenue by preventing a distortion which would be detrimental to the Government. In holding that the Commissioner's 1950 decision requiring petitioner to use the $1 per unit method of inventorying used trailers was a mistake of law, the decision below ran counter to the decision of this Court in the *Dobson* case.

II. The Decision Below Involves an Important Question of Federal Tax Law Upon Which This Court Has Not Ruled Directly, But Which Should be Settled by a Decision of This Court

This Court has stated in several decisions that the Commissioner is given very broad discretion by Section 41 of the 1939 Code and Section 446(b), the corresponding provision of the 1954 Code, in determining the method of accounting to be used by a taxpayer.

In *Lucas* v. *American Code Co.*, 280 U.S. 445, 449 (1930), this Court said:

> "And the direction that net income be computed according to the method of accounting regularly employed by the taxpayer is expressly limited to cases where the Commissioner believes that the accounts clearly reflect the net income. Much latitude for discretion is thus given to the administrative board charged with the duty of enforcing the Act. Its interpretation of the statute and the practice adopted by it should not be interfered with unless clearly unlawful."

And in *Brown* v. *Helvering*, 291 U.S. 193, 203 (1934), the Court stated:

> "Moreover, the method employed by the taxpayer is never conclusive. If in the opinion of the Commissioner it does not clearly reflect the

income, 'the computation shall be made upon such basis and in such manner,' as will, in his opinion, do so. *United States* v. *Anderson,* 269 U.S. 422, 439; *Lucas* v. *American Code Co.,* 280 U.S. 445, 449; *Lucas* v. *Ox Fibre Brush Co.,* 281 U.S. 115, 120; compare *Williamsport Wire Rope Co.* v. *United States,* 277 U.S. 551; *Lucas* v. *Structural Steel Co.,* 281 U.S. 264. In assessing the deficiencies, the Commissioner required in effect that the taxpayer continue to follow the method of accounting which had been in use prior to the change made in 1923. To so require was within his administrative discretion; compare *Bent* v. *Commissioner,* 56 F. (2d) 99."

More recently, the Court, in *Commissioner* v. *Hansen,* 360 U.S. 446, 467 (1959), said:

"The Commissioner had broad powers in determining whether accounting methods used by a taxpayer clearly reflect income, *Lucas* v. *American Code Co.,* 280 U.S. 445, 449; *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180, 189-190, and under § 41 * * * the Commissioner, believing that the accounting method employed by a taxpayer 'does not clearly reflect the income,' may require that 'computation shall be made in accordance with such method as in [his] opinion . . . does clearly reflect the income.'"

The most recent discussion by this Court of the broad discretion given the Commissioner over methods of accounting was in the opinion of Mr. Justice Stewart in *United States* v. *Catto,* No. 535, October Term, 1965, 86 S. Ct. 1311, 1318, where it was said:

"Congress has granted the Commissioner broad discretion in shepherding the accounting methods used by taxpayers, and the uniform application of the unit-livestock-price method to the respondents' entire livestock operation is a reasonable

> exercise of the discretion rested by Congress in the Secretary and the Commissioner for the administration of the tax laws. 'It is not the province of the court to weigh and determine the relative merits of systems of accounting.' *Brown* v. *Helvering,* 291 U.S. 193, 204-205; *Lucas* v. *American Code Co.,* 280 U.S. 445, 449; *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180, 189-190; *Commissioner* v. *Hansen,* 360 U.S. 446, 467; *Schlude* v. *Commissioner,* 372 U.S. 128, 133-135."

While frequently enunciating the general rule as to the Commissioner's wide discretion in the accounting field, this Court has never decided the question of whether the Commissioner's discretion is broad enough to permit him to require a taxpayer to continue the use of a particular accounting method, where such method is erroneous, in order to prevent a distortion of income which would result in a tax detriment to the Government. The number of disputes which may arise in the field of tax accounting is virtually unlimited. The statement which Mr. Justice Jackson made over twenty years ago in the *Dobson* case, *supra,* is no less true today. He said (p. 499):

> "The mere number of such questions [disputes over proper accounting] and the mass of decisions they call forth become a menace to the certainty and good administration of the law."

The decision below casts doubt on the extent to which the Commissioner's discretion in the accounting area goes, a doubt which is not shared by the Courts of Appeals for the Second and Third Circuits or by the Court of Claims. The extent of the Commissioner's discretion in the accounting area is a recurring question, affecting numerous taxpayers, and

all doubt as to the authority of the Commissioner to require a taxpayer to use a method of accounting which is erroneous, where to permit the use of a correct method would result in a double deduction and a detriment to the revenue, should be resolved by this Court.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the writ of certiorari should be granted.

Respectfully submitted,

ALFONS LANDA
RAYMOND C. CUSHWA
GEORGE D. WEBSTER
Attorneys for Petitioner
1000 Vermont Ave., N. W.
Washington, D.C. 20005

Of Counsel:

DAVIES, RICHBERG, TYDINGS,
LANDA & DUFF
Washington, D. C.